The Treasury

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Inland Revenue
Te Tari Taake

POLICY ADVICE DIVISION

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Cabinet paper: Taxation of non-resident investment in portfolio investment entities

Date:	28 March 2011	**Priority:**	Medium
Security Level:		**Report No:**	PAD 2011/065 T2011/565

Action sought

	Action Sought	Deadline
Minister of Finance	**Sign** and **refer** the attached Cabinet paper to Cabinet and **refer** a copy of the attached paper to the Prime Minister and the Minister for Economic Development.	Before 10am Thursday 31 March
Minister of Revenue	**Sign** and **refer** the attached Cabinet paper to Cabinet and **refer** a copy of the attached paper to the Prime Minister and the Minister for Economic Development.	Before 10am Thursday 31 March

Contact for telephone discussion (if required)

Name	Position	Telephone
Steve Mack	Principal Advisor, The Treasury	[1]
[1]		

Minister of Finance
Minister of Revenue

Cabinet paper: Taxation of non-resident investment in portfolio investment entities

Attached for your signature and referral is a Cabinet paper for Cabinet to consider at its meeting on Monday 4 April 2011. This paper needs to be referred to the Cabinet Office by 10am, Thursday 31 March.

Officials recently reported to you seeking your agreement to a proposal to amend the tax treatment of non-resident investment in portfolio investment entities (PAD2011/042; T2011/368 refers).

The proposal follows on from recommendations by the Jobs Summit and the International Financial Services Development Group ("IFSDG") that non-residents investing in foreign assets through a portfolio investment entity ("PIE") be taxed at zero percent on foreign-sourced income derived through the PIE, as a way of encouraging the establishment of an international investment funds domicile in New Zealand. Such income is currently taxed at 28 percent, which results in PIEs being unattractive to non-resident investors. By contrast, if the non-resident invested directly into foreign assets, the income would generally be taxed at zero percent. This is because of the principle that non-residents are only subject to New Zealand tax on their New Zealand-sourced income.

The attached paper seeks Cabinet's approval to amend the tax rules to ensure that non-resident investors in PIEs can be subject to the same tax rates on their foreign and New Zealand-sourced income as if they invested directly (this will result in a nil tax rate on foreign-sourced income).

Recommended action

It is recommended that you:

a) **Sign** and **refer** the attached paper to the Cabinet Office by 10am, Thursday 31 March.

Signed and referred	Signed and referred

b) **Refer** a copy of this report and the attached paper to the Prime Minister and the Minister for Economic Development, for their information.

Referred	Referred

Steve Mack for Secretary to the Treasury	**David Carrigan** Policy Manager Inland Revenue

Hon Bill English Minister of Finance	**Hon Peter Dunne** Minister of Revenue

Office of the Minister of Finance
Office of the Minister of Revenue

Chair
Cabinet

TAXATION OF NON-RESIDENT INVESTMENT IN PORTFOLIO INVESTMENT ENTITIES

PROPOSAL

1. This Cabinet paper seeks agreement to include changes to the Income Tax Act 2007 and the Tax Administration Act 1994 in a Supplementary Order Paper ("SOP") to the Taxation (Tax Administration and Remedial Matters) Bill 2010, to amend the tax treatment of non-resident investment in portfolio investment entities ("PIEs"). This includes introducing a zero percent tax rate for foreign-sourced income earned by non-residents through a PIE.

EXECUTIVE SUMMARY

2. The Jobs Summit and the International Financial Services Development Group ("IFSDG") both recommended that non-residents investing in foreign assets through a PIE should be taxed at zero percent on foreign-sourced income derived through the PIE, as a way of encouraging the establishment of an international investment funds domicile in New Zealand. Such income is currently taxed at 28 percent, which results in PIEs being unattractive to non-resident investors. By contrast, if the investor invested directly into foreign assets, the income would generally be taxed at zero percent. This is because of the principle that non-residents are only subject to New Zealand tax on their New Zealand-sourced income.

3. Officials have recently consulted on a proposal to amend the tax treatment of non-resident investors in PIEs so that they are subject to similar tax rates on their PIE income as they would be if they invested directly. This proposal includes introducing a zero percent tax rate on foreign-sourced income that is earned by non-residents through a PIE.

4. This paper seeks agreement to amend the tax legislation to give effect to this proposal.

BACKGROUND

5. The Jobs Summit and the IFSDG both recommended that non-residents investing in foreign assets through a PIE should be taxed at zero percent on foreign-sourced income earned through the PIE, in order to facilitate the establishment of New Zealand as an international investment funds domicile. Foreign-sourced income is currently taxed at 28 percent, which results in PIEs being unattractive to non-resident investors. This is because if

the non-resident invested directly into foreign assets, the income would generally be taxed at zero percent. This is a result of the principle that non-residents should only be subject to New Zealand tax on their New Zealand-sourced income.

6. Officials have been working on the design of a proposal which would ensure that non-resident investors in PIEs are taxed in a roughly equivalent manner to how they would be taxed on foreign-sourced and New Zealand-sourced income if they invested directly instead of through a PIE.

7. An officials' issues paper *Allowing a zero percent tax rate for non-residents investing in a PIE* was released in April 2010. The paper outlined two options. Option 1 allowed resident and non-resident investors to invest in a PIE that derived only foreign-sourced income, which would be taxed at zero percent. Option 2 allowed a PIE to have both resident and non-resident investors and New Zealand and foreign-sourced income but with different PIE tax rates applying to different types of income derived by non-resident investors.

8. Cabinet agreed late last year to include legislation enacting the proposal in a tax bill on or around Budget day this year, with a shortened referral to the Finance and Expenditure Committee ("FEC") and enactment by the end of August 2011 (CAB Min (10) 44/19 refers).

COMMENT

9. After taking into account feedback received during consultation with the managed funds industry, it is proposed that funds should be able to elect into two new categories of PIE (corresponding to the two options outlined in the April issues paper). This will provide flexibility to both PIEs and non-resident investors in terms of investment into foreign or New Zealand assets.

10. The first category of PIE ("Category 1") is one that could have both resident and non-resident investors and derive only foreign-sourced income but with a *de minimis* of 5 percent for New Zealand-sourced interest income. The rationale for the *de minimis* is to ensure that PIEs can hold sufficient cash reserves to meet applications, redemptions and day-to-day expenses, without disqualifying the Category 1 PIE. We also propose a *de minimis* of 1 percent for holding New Zealand shares, as it would allow funds which track a global index, and hold some New Zealand equities as part of this, to elect into the Category 1 PIE option.

11. The second category of PIE ("Category 2") is one that could have both resident and non-resident investors and both New Zealand and foreign-sourced income. Non-resident investors would be subject to roughly the same tax treatment on the income that they earn as would apply if they had invested directly. Accordingly, the PIE would have to track different income types and apply different rates as follows:

Foreign-sourced income	0 percent
Imputed dividends from NZ equities	0 percent
Unimputed dividends from NZ equities where investor is from a country with which NZ has a double tax agreement	15 percent
Unimputed dividends from NZ equities where investor	

is from a country with which NZ has no double tax agreement	30 percent
Gains on NZ equities	0 percent[1]
Interest income from NZ financial arrangements	1.44 percent[2]
Other NZ income	28 percent

12. A key measure to simplify the proposal outlined above is to add a restriction preventing the two new PIE categories from investing directly into New Zealand land. This would remove the need for PIEs to attribute deductions and expenses with respect to their non-resident investors. We could then have a blanket rule prohibiting any deductions for non-residents investing in Category 2 PIEs. This is consistent with the treatment that applies currently where a non-resident invests directly – no deductions are allowed in relation to foreign-sourced income or New Zealand-sourced income taxed on a gross basis (e.g. interest and dividends paid to non-residents). The only deductions that are allowed to non-resident investors are those relating to New Zealand-sourced income which is taxed on a net basis (essentially income from land).

13. The new PIEs would be required to meet the normal eligibility criteria (and exceptions) in the existing legislation for being treated as a PIE. This is to ensure that these PIEs are passive portfolio investment vehicles and are not able to undertake investments in active businesses.

14. The application date proposed for the changes is generally 1 April 2012. However, the proposed application date for the Category 1 PIE is earlier, being the date of enactment. The reason for this is that it will assist funds which are ready to launch before 1 April 2012.

15. The amendments will also include a mechanism for allowing the new PIEs to choose to deduct non-resident withholding tax ("NRWT") on unimputed dividends instead of paying PIE tax on the income. This will enable non-resident investors to receive a foreign tax credit in their home jurisdiction for New Zealand tax paid on their PIE unimputed dividend income, which makes investment into the PIE more attractive.

16. We propose that information and return obligations for the new PIEs would generally be the same as those that apply to existing PIEs, with some amendments. The key addition is that the new PIEs will be required to request certain information from their non-resident investors, in order to facilitate meeting OECD exchange of information obligations, i.e. the tax file number of the non-resident in their home country, or if this cannot be provided, a declaration stating that the investor is unable to provide this information.

CONSULTATION

17. The Treasury and Inland Revenue have been consulted.

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[1] This is the existing treatment for gains on New Zealand equities earned by PIEs.
[2] This is equivalent to the net rate of the approved issuer levy ("AIL"), which is deductible to the approved issuer.

18. In addition, officials have undertaken consultation with the managed funds industry and tax advisors on the design of the proposal.

19. The funds industry and tax advisors expressed widespread support for both the proposed PIE tax changes, as well as the wider financial hub proposal. However, they considered it important that the new rules should be optional for funds to elect into.

20. The key issue that was raised during consultation was the need for simplicity and flexibility to cater for the diverse range of systems which PIEs have in place. Concerns were raised about the complexity of Category 2, in particular, the need to track different types of income and apply different rates to these types. Accordingly, a key theme from feedback was the desirability of reducing the number of rates that would need to apply under Category 2. In particular, applying AIL at 0 percent instead of 1.44 percent, in line with the changes contained in the Taxation (International Investment and Remedial Matters) Bill 2010 in relation to widely-held bonds was mooted. In addition, submitters floated the idea of removing the 30 percent rate for unimputed dividends where non-resident investors are from countries with which New Zealand does not have a DTA.

21. We consider that AIL should remain at 1.44 percent and the NRWT rate for unimputed dividends paid to non-resident investors from non-DTA countries should remain at 30 percent. Retaining the 1.44 percent rate of AIL and 30 percent NRWT rate will ensure that non-residents investing in the Category 2 PIEs will be subject to the same tax rate on their foreign and New Zealand-sourced income as if they invested directly.

22. A number of minor technical issues were also raised, which officials will work through when drafting the legislation.

ADMINISTRATIVE COST IMPLICATIONS

23. Preliminary cost estimates to adapt current systems and processes in order to implement two new categories of Foreign Investor PIE are in the range of $450,000 to $650,000 for operating and $800,000 to $1m for capital costs and are expected to be incurred in 2011/12.

24. These initiatives have been marginally costed based on our initial assessment of implementing this solution and should be treated with caution. The estimated administrative costs are dependent on proposal development and final decisions on the most appropriate approach.

25. Inland Revenue has assessed the ability to fund smaller self-contained initiatives within the context of overall affordability of Budget 2011 and other proposed legislative changes and at this stage has capacity to absorb the above costs from within its baseline appropriation.

FINANCIAL IMPLICAITONS

26. The approximate fiscal cost of the proposed PIE tax changes are as follows:

Vote Revenue **Minister of Revenue**	$ millions increase / (decrease)				
	2010/11	2011/12	2012/13	2013/14	2014/15
Crown Revenue and Receipts: Tax Revenue	-	(5.000)	(10.000)	(10.000)	(10.000)

27. The proposed amendments outlined above would not impact on the Budget by themselves. However, items on the tax policy work programme are aggregated periodically and would reduce the between-Budget contingency accordingly if they are negative in total at each report back. Overall, the tax policy work programme, as agreed by Cabinet, is expected to be revenue positive or neutral (CBC Min (09) 5/2 refers). Including the financial implications of this report, items on the tax policy work programme that have been agreed since the 2009 Budget are estimated to, in total, increase Crown revenue by $6.1 million across the forecast period.

HUMAN RIGHTS

28. The proposals included in this paper are consistent with the rights and freedoms affirmed in the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

LEGISLATIVE IMPLICATIONS

29. Cabinet has previously agreed to introduce legislation to implement the proposed changes on or around Budget day this year, with a shortened referral to the Finance and Expenditure Committee ("FEC") and enactment by the end of August 2011.

30. Accordingly, it is recommended that the proposal should be included in the Taxation (Tax Administration and Remedial Matters) Bill 2010, which is currently before FEC, by means of an SOP. The Minister of Revenue would release the SOP once it is finalised and invite FEC to consider it as part of the bill, without further referral to Cabinet.

31. The application dates will be either the date of Royal assent (for the Category 1 PIE) or 1 April 2012 (for the Category 2 PIE).

REGULATORY IMPACT ANALYSIS

32. The Regulatory Impact Analysis requirements apply to the proposal. A Regulatory Impact Statement (RIS) is attached.

33. The Work Programme Manager, Policy Advice Division has reviewed the *Taxation of Non-Resident Investment in Portfolio Investment Entities* RIS and considers that the information and analysis summarised in it meets the quality assurance criteria of the Regulatory Impact Analysis framework.

34. The RIS considers how the current over taxation of non-resident investment in PIEs may be removed. The problem is well defined and status quo clearly articulated, reflecting a clear barrier to investment from non-residents and how this would continue. The objectives which follow relate logically to and fully cover the problem definition, it is noted that the objectives have been constrained to an extent by OECD principles.

35. The RIS identifies two options to remove the over-taxation of non-resident investors in PIEs; both options have been fully developed. No social, cultural or environmental impacts are anticipated and the economic impacts are outlined.

36. There is clear evidence of efficient and effective consultation with all relevant stakeholders, key affected parties, government agencies and relevant experts. The issues raised during consultation have been addressed.

37. The included agency disclosure statement identifies no significant constraints, caveats or uncertainties concerning the regulatory analysis.

38. We have considered the analysis and advice of officials, as summarised in the attached RIS and are satisfied that, aside from the risks, uncertainties and caveats already noted in this Cabinet paper, the regulatory proposals recommended in this paper:

- are required in the public interest
- will deliver the highest net benefits of the practical options available, and
- are consistent with our commitments in the Government statement *Better Regulation, Less Regulation*.

PUBLICITY

39. The Minister of Revenue will make an announcement when the SOP is released. Inland Revenue will publish details about the new legislation in the *Tax Information Bulletin* when the Taxation (Tax Administration and Remedial Matters) Bill 2010 is enacted.

RECOMMENDATIONS

40. It is recommended that Cabinet:

1. **Note** that under current law, non-resident investors in portfolio investment entities ("PIEs") are subject to tax at 28 percent on all income derived through PIEs, including foreign-sourced income;
2. **Note** that the Jobs Summit and the International Financial Services Development Group (IFSDG) have both recommended that non-residents investing in foreign assets through a PIE be taxed at a nil rate on foreign-sourced income derived through the PIE, as a way of encouraging international investment funds to domicile in New Zealand;
3. **Agree** to the introduction of a new category of PIE which entities could elect into ("Category 1") that has both resident and non-resident investors and only foreign-sourced income taxed at zero percent for non-resident investors, subject to a 5

percent *de minimis* for New Zealand-sourced interest income and a 1 percent *de minimis* for New Zealand-sourced income from equities;

4. **Agree** to the introduction of a new category of PIE which entities could elect into ("Category 2") that has both resident and non-resident investors and both foreign-sourced income and New Zealand-sourced income, with non-residents subject to tax rates which are consistent with those that would apply to direct investment:

   (i) 0 percent on foreign-sourced income

   (ii) 0 percent on dividends derived from New Zealand companies that are fully-imputed;

   (iii) 15 percent on dividends derived from New Zealand companies that are unimputed where the investor is from a country with which New Zealand has a double tax agreement ("DTA");

   (iv) 30 percent on dividends derived from New Zealand companies that are unimputed where the investor is from a country with which New Zealand does not have a DTA;

   (v) 1.44 percent on New Zealand-sourced interest income (being the effective approved issuer levy ("AIL") rate if the borrower is allowed a deduction for the AIL paid);

   (vi) 28 percent on other New Zealand-sourced income;

5. **Agree** that the new PIEs will not be able to invest directly into New Zealand land or land investment companies;

6. **Agree** that no deductions for expenses will be attributable to non-resident investors in a Category 1 or Category 2 PIE (as deductions are not permitted against income that is foreign-sourced or taxed on a gross basis e.g. interest and dividends paid to non-residents);

7. **Agree** that the two new PIE categories would generally be required to meet the existing eligibility criteria (subject to recommendation 5 (and exclusions)) set out in the legislation for entities to be treated as PIEs;

8. **Agree** that the two new PIE categories would generally be required to meet the existing PIE information and return requirements, with the exception of being required to request certain additional information in order to satisfy New Zealand's obligations to exchange information with other jurisdictions.

9. **Agree** that Category 2 PIEs should have the option to withhold non-resident withholding tax on unimputed dividends paid to non-resident investors instead of paying PIE tax on that income;

10. **Agree** that legislative amendments should be made to ensure that New Zealand resident investors cannot benefit from the lower tax rates applying to non-resident PIE investors by investing into the two new PIE categories via foreign entities;

11. **Agree** that the application date for the Category 1 PIE should be the date of enactment of the legislation;

12. **Agree** that the application date for the Category 2 PIE should be 1 April 2012;

13. **Note** that agreeing to recommendations 3-12 will result in the following reduction in tax revenues, with a corresponding impact on the operating balance:

	$ millions increase / (decrease)				
Vote Revenue **Minister of Revenue**	2010/11	2011/12	2012/13	2013/14	2014/15
Crown Revenue and Receipts: Tax Revenue	-	(5.000)	(10.000)	(10.000)	(10.000)

14. **Note** that Cabinet has previously agreed to introduce legislation to implement the proposed changes on or around Budget day this year, with a shortened referral to the Finance and Expenditure Committee ("FEC") and enactment by the end of August 2011;

15. **Agree** that legislation to implement the proposed changes be included in the Taxation (Tax Administration and Remedial Matters) Bill 2010 by means of a Supplementary Order Paper ("SOP"), without further referral to Cabinet;

16. **Agree** that the Minister of Revenue may release the SOP as soon as it is ready.

Hon Bill English
Minister of Finance

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____/____/_____
Date

Hon Peter Dunne
Minister of Revenue

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___/____/_____
Date